A Comparative Literature Survey of Islamic Finance and Banking

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There has been large-scale growth in Islamic finance and banking in Muslim countries and around the world during the last twenty years. This growth is influenced by factors including the introduction of broad macroeconomic and structural reforms in financial systems, the liberalization of capital movements, privatization, the global integration of financial markets, and the introduction of innovative and new Islamic products. Islamic finance is now reaching new levels of sophistication. However, a complete Islamic financial system with its identifiable instruments and markets is still very much at an early stage of evolution. Many problems and challenges relating to Islamic instruments, financial markets, and regulations must be addressed and resolved. In this paper, we provide a comprehensive comparative review of the literature on the Islamic financial system. Specifically, we discuss the basic features of the Islamic finance and banking. We also introduce Islamic financial instruments in order to compare them to existing Western financial instruments and discuss the legal problems that investors in these instruments may encounter. The paper also gives a preliminary empirical assessment of the performance of Islamic banking and finance, and highlights the regulations, challenges and problems in the Islamic banking market.

I. INTRODUCTION

Islamic finance was practiced predominantly in the Muslim world throughout the middle ages. European financiers and businessmen later adopted many concepts, techniques, and instruments of Islamic finance. In contrast, the term "Islamic financial system" is relatively new, appearing only in the mid-1980s. In fact, all earlier references to commercial or mercantile activities conforming to Islamic principles were made under the umbrella of either "interest free" or "Islamic" banking. This, no doubt, prohibits the receipt or payment of interest as the nucleus of the system, but is supported by other principles of Islamic doctrine advocating risk sharing, individuals' rights and duties, property rights, and the sanctity of contracts. Similarly, the Islamic financial system is not limited to banking, but covers financial instruments, financial markets, and all types of financial intermediation.

There is a debate among the Islamic community over the effectiveness of an interest-based banking system. While it is acknowledged that banks play a pivotal role in the development of a country through their role as financial intermediaries, the question is how efficient an interest-based system is in

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performing this function. In fact, there is even some debate as to whether or not an interest-based system actually contributes to cyclical fluctuations. A new system of banking has emerged known as Profit-Loss-Sharing (PLS) most likely in response to the interest-based banking system debate, but more due to religious beliefs in the Islamic community. Currently, this banking system is integrated into over 60 countries throughout the world with over 250 Islamic financial institutions in operation.

Aside from the economic debate, the main contributing factor in the emergence of a PLS-banking system is the prohibition of 'riba' (or interest) in the holy Quran. The basic intention behind establishing Islamic banks was the desire of Muslims to reorganize their financial activities to complement the principles of the Shariah (the Islamic Law) and enable them to conduct their financial transactions without indulging in 'riba'. The term riba is used in the Shariah in two senses. First is riba al-nasi'ah, which is the fixing in advance of a positive return on a loan as a reward for waiting to be repaid. Second, riba al-fadl, is encountered in a hand-to-hand purchase and sale of commodities. The Shariah prohibits both forms of 'riba'. Clearly, with regard to riba al-nasi'ah, the prohibition is on an increase occurring from the mere use of money with no measurable real economic increase. On the other hand, the Islamic community does not consider an increase in business activity derived from invested money 'riba'. It is important to realize that the Islamic community has no objection to true profit as a return on entrepreneurial efforts that benefits all of society. Furthermore, in the case of riba al-fadl, the Islamic community is only interested in ensuring justice and fair play in spot transactions to avoid any exploitation through unfair exchanges.

While the original basis for the prohibition of interest was divine authority, recently Muslim scholars have placed a major emphasis on the lack of a theory for interest. Muslim scholars have rebutted the arguments that interest is a reward for savings, a productivity of capital, and provides for the difference between the value of capital goods today and their value tomorrow. In terms of interest being a reward for savings, they argue that interest could only be justified if it resulted in reinvestment and subsequent growth in capital and not solely as a reward for forgoing consumption. With regard to the productivity of capital argument, modern Muslim scholars argue that the interest is paid on the money and is required regardless of whether or not capital productivity results, and thus is not justified. Finally, with regard to the argument that interest enables an adjustment between the values of capital goods today with their value tomorrow, the response is that this only explains its inevitability and not its rightness. Specifically, if that is the sole justification for interest, it seems more reasonable to allow next year's economic conditions to determine the extent of the reward, as opposed to predetermining it in the form of interest.

The Islamic community has rationalized the elimination of riba (interest) based upon values of justice, efficiency, stability and growth. In terms of

justice, the removal of riba results in the sharing of the risk of a project between the borrower and the lender. In addition, by tying the reward to the performance of the business venture, the resulting returns are more equitable during good times and bad times. Finally, returns are only earned when the business venture results in the addition of value, which benefits all of society. Regarding the efficiency of allocation of capital argument, interest based lending with adjustments for risk capital tends to result in serving the more creditworthy borrowers and not necessarily the most productive projects. The Islamic PLS- banking allocates financing to the most productive business ventures, as the share in returns is more promising. In addition, profit sharing results in both the borrower and lender working more closely together to ensure the business venture's success, which is more productive for society. Finally, Muslim economists argue that the PLS system provides for cohesion between social classes because financing is equally available to anyone with a productive idea. With regard to the subject of stability, Muslim economists argue that an interest-based banking system fosters inflation, as the creation of money does not have any direct tie to whether or not a business venture is productive. The result is a higher cost to society for failed projects that interest was paid without any economic benefits.

There are many legally recognized forms of business arrangements in Islam, which are derived from four main sources of Islamic law: the Quran, the sunnah, the ijma, and the qiyas. Although modern Islamic banking is considered to be a recent development, it has a long historic background with its earliest beginnings being traced to the practice of mudaraba (an ancient form of partnership) used by the Prophet Muhammad (Peace be upon him) himself. Another earlier business arrangement known as Musharaka was also prevalent in ancient times. Both of these business arrangements are essentially agency arrangements. The difference between the two is that in the latter, the agent contributes to the capital for the project and thus may receive a higher share of the profits and losses of the business venture. The former relieves the agent from any loss potential, but provides for a lower share of the profit. Therefore, modern Islamic banking was derived from these earlier forms of business relationships, with the disparity being that today lenders are brought together in a centralized location, the bank, so that their money can be lent to entrepreneurs for investment in new business ventures.

In this paper we provide a comprehensive review of the literature on the Islamic financial system. In section II we discuss the basic features of Islamic finance and how they relate to traditional Western finance. In section III we introduce the Islamic financial contracts that are currently utilized by Islamic financial institutions around the world, and include a comparison of them to existing Western financial instruments. We also discuss the legal problems that investors in these instruments may encounter. Section IV reviews the progress and growth in a major component of the Islamic financial system, the Islamic banking market. Section V gives a synopsis of Islamic banking and finance

experiences in Pakistan, Iran and Sudan. Section VI gives a preliminary empirical assessment of the performance of Islamic banking and finance. Section VII discusses the current practices and regulations of Islamic banking and finance. Section VIII highlights the challenges and problems facing the Islamic banking market. Section IX discusses the prospects and challenges for development of another Islamic financial market, the equity market, and Section X concludes the paper.

II. BASIC FEATURES OF ISLAMIC FINANCE

Islamic finance is a financial system, the fundamental aim of which is to fulfill the teaching of the Holy Quran, as opposed to reaping maximum returns on financial assets. The basic principle in the Sharia (Islamic Common Law) is that exploitative contracts based on Riba (interest or usury) or unfair contracts that involve risk or speculation (Gharar) are unenforceable. However the Holy Quran contains no condemnation of morally acceptable investments that yield fair/legitimate profits and economic/social "added-value" (Siddiqi 1999). Two more principles are fundamental to understanding Islamic finance. First, the Islamic law reflects the totality of Allah' (God's) commands that regulate all aspects of the life of a Muslim. Second, Islamic finance is directly involved with spiritual values and social justice. Under Islam, there is no separation of mosque and state or of business and religion (Nicolas 1994).

The fact that Islamic laws prohibit Muslims from paying or receiving interest, prevents observant Muslims from taking out mortgages, carrying balances on credit cards or investing in any fixed income securities such as T-bonds, T-Bills, CDs or any other financial security that promises a guaranteed return. This does not imply that Islam frowns on making money or demands that Muslims revert to an all-cash or barter economy, but means that all parties to a financial transaction share the risk and profit or loss of a venture, and that no one party to a financial contract gets predetermined return. For example, "depositors" in Islamic banks are really shareholders who earn dividends when the bank turns a profit, or lose a portion of their savings if it posts a loss. In effect, the Islamic financing functions much like Western equity financing. Investors and lenders have the right to a decent rate of return; it is just the certainty of the return that is an issue. This direct correlation between investment and profit differentiates Islamic banking from conventional or western banking, which defines maximization of the shareholders' wealth as the sole objective of the firm.

While the banning of interest is rooted in the Islamic theology, proponents of Islamic finance provide economic rationales to support the ban of interest. Some of these rationales are described by the International association of Islamic banks (1995, pp. 3-4). First, in an Islamic profit sharing contract, the return on capital will depend on productivity, and the allocation of funds will be primarily based on the soundness of the project. This will improve the

capital allocation efficiency. Second, the Islamic profit-sharing system will ensure more equitable distribution of wealth and the creation of additional wealth to its owners. This system would no doubt reduce the unjust distribution of wealth under the interest system.

Third, the profit sharing regime may increase the volume of investments and hence create more jobs. The interest regime would make feasible and acceptable only those projects whose expected returns are higher than the cost of debt, and therefore filter out projects which are otherwise acceptable under the Islamic profit-sharing system. Fourth, the Islamic finance system will reduce the size of speculation in financial markets, but still allow for a secondary market for trading stocks and investment certificates based on profit sharing principles. This will bring sanity back to the financial market and promote liquidity to equity holders. Fifth, under the profit-sharing system, the supply of money is not allowed to overstep the supply of goods and would thus curb inflationary pressures in the economy.

Some Islamic bankers argue that Islamic finance may even have a role to play in underpinning the stability of the international economy (Dudley 1998). Under the Islamic financing system, investments or finance is targeted to the specific needs of an entity. Financiers or investors will need to satisfy themselves as to the reliability of a project, their lease rentals or the return promised in any financing deal. The investors and financiers have to exercise due diligence and careful monitoring of their investments. There is not much room for raising a variety of unsecured debts that are not targeted to the specific needs of borrowers. Conventional Western financing, on the other hand, lacks a corrective mechanism to stop excessive borrowing beyond individual companies' means. In good times, raising funds is easy, while in bad times the cost of raising funds is high; therefore, the risk to the financing institution is increased. The amount of borrowing under a conventional system is several times more than it would be under an Islamic system, and so are the risks inherited from these excessive borrowings.

III. ISLAMIC FINANCING CONTRACTS

There are five basic Islamic Financing contracts. The underlying concept for each technique is simple and can be compared to an existing Western financial instrument. However, actual financing deals can become very complicated as some banks modify the structure to suit the requirements of specific investors. These deals may contain elements of more than one of the basic Islamic contracts. In this section we discuss the basic features of these Islamic financing contracts. We also discuss some of the legal problems that investors in these instruments may encounter. Table 1 presents various modes of Islamic finance.

Murabaha

A Murabaha transaction is basically a cost-plus profit financing transaction in which a tangible asset is purchased by an Islamic institution at the request of its customer from a supplier. The Islamic institution then sells the asset to its customer on a deferred sale basis with a mark-up reflecting the institution's profit. The customer takes the responsibility of negotiating all of the key commercial terms with the seller of the asset. The mark-up on the asset cannot be altered during the life of the contract. The size of the mark-up is determined in relation to an interest rate index such as the LIBOR (London Inter-Bank Offered Rate) or US- short T-bills rate, and is also a function of the client's credit rating, the transaction's size and the type of goods being financed. The Murabaha deals offer enough flexibility to be used in real estate and project financing, but historically it has been used primarily for trade finance.

A number of legal issues may be encountered by the Islamic financial institutions that finance a Murabaha transaction. First, the Islamic financial institution cannot earn excessive profits from the client. If the profit is excessive, remedies may include a return of the "excessive" portion of the profit to the client. A second legal issue is rejection of the goods. The customer may reject the goods for non-conformity and leave the bank holding the goods. To eliminate the possibility of rejection of goods, the customer will generally act as the bank's agent in determining the conformity of the goods prior to acceptance. Finally, the Islamic financial institution may be exposed to contractual and statutory liabilities (such as warranties) resulting from its ownership of the goods. These should be disclaimed to the extent possible or be limited by indemnities received from the customer.

Ijara and Ijara wa-Iqtina (Islamic leasing)

Ijara and Ijara wa-Iqtina are Islamic leasing concepts similar to western operating and finance leases. Ijara is similar to a conventional operating lease, where in an Islamic bank (lessor) leases the asset to a client (lessee) for agreed on lease payments for a specified period of time, but with no option of ownership for the lessee. The maintenance and insurance of the leased asset is the lessor's responsibility. On the other hand, Ijara wa-Iqtina is comparable to the Western financial or capital lease, where the lessee has the option of owning the asset at the termination of the lease. In this case, the bank (lessor) purchases the asset such as a building, piece of equipment or even an entire project and leases it to the clients for an agreed on lease rental, together with client agreement to make lease payments towards the purchase of the asset from the lessor. The conditions governing both types of leasing are that assets must have a long/secure productive life, and must not be handled in an

Table 1

TYPE	DESCRIPTION	COMMENTS
PLS Modes	Profit and loss sharing modes	At the core of Islamic banking
	Trustee finance contract	
Mudarabah	The bank provides the entire capital needed for financing a project, while the entrepreneur offers his labor and expertise. The profits (or losses) from the project are shared between the bank and the entrepreneur at a certain fixed ratio. Financial losses are borne exclusively by the bank. The liability of the entrepreneur is limited only to his time and efforts. However, if the negligence or mismanagement of the entrepreneur can be proven he may be held responsible for the financial losses incurred.	Three conditions need to be met: 1. The bank should not reduce credit risk by requesting collateral to this purpose: it bears entirely and exclusively the financial risk. Collateral may be requested to help reduce moral hazard, e.g., to prevent the entrepreneur from running away. 2. The rate of profit has to be determined strictly as a percentage and not as a lump sum. 3. The entrepreneur has the absolute freedom to manage the business.
	It is usually employed in investment projects with short gestation periods and in trade and commerce.	The bank is entitled to receive from the entrepreneur the principal of the loan at the end of the period stipulated in the contract, if and only if a surplus exists. If the enterprise's books show a loss, this will not constitute default on the part of the entrepreneur, except for negligence or mismanagement.

Table 1: (Continued)

TYPE	DESCRIPTION	COMMENTS
PLS Modes	Profit and loss sharing modes	At the core of Islamic banking
	It affects both assets and liabilities sides of banks' balance sheet. On the liabilities side, the contract between the bank and depositors is known as *unrestricted Mudarabah* because depositors agree that their funds be used by the bank, at its discretion, to finance an open-ended list of profitable investments and expect to share with the bank the overall profits accruing to the bank's business. On the assets side, the contract between the bank and the agent-entrepreneur is known as a *restricted Mudarabah* because the bank agrees to finance a specific project carried out by a specific agent-entrepreneur and to share the relative profits according to a certain percentage.	
	Equity participation contract	
Musharakah	The bank is not the sole provider of funds to finance a project. Two or more partners contribute to the joint capital of an investment. Profits (and losses) are shared strictly in relation to the respective capital contributions. It is usually employed to finance long-term investment projects.	Banks can exercise the voting rights of corresponding to their share of the firm's equity capital. Their representatives can sit in the firm's board of directors. All parties invest in varying proportions, and have the right to participate in the management of the enterprise.

Non-PLS Modes	Non Profit and loss sharing modes	They are used in cases where PLS modes cannot be implemented, for example, in cases of small-scale borrowers or for consumption loans.
	Beneficence loans	
Qard al-Hasanah	These are zero-return loans that the Quran exhorts Muslims to make to "those who need them." Banks are allowed to charge the borrowers a service fee to cover the administrative expenses of handling the loan, provided that the fee is not related to the amount or maturity of the loan.	Contrary to contracts based on the PLS principle, modes such as markup, leasing, and lease purchase have a predetermined and fixed rate of return and are associated with collateral.
	Leasing Lease purchase	
Ijara Ijara wa iqtina'	A party leases a particular product for a specific sum and a specific period of time. In the case of a lease-purchase, each payment includes a portion that goes toward the final purchase and transfer of ownership of the product.	In fact, banks add a certain percentage to the purchase price and/or additional costs associated with these transactions as a profit margin, and the purchased assets serve as a guarantee. Additionally, banks may require the client to offer a collateral. These instruments can be considered to be more closely associated with risk aversion and they do not substantially differ from those used in a conventional banking system, other than in their terminology and in some legal technicalities. They are considered to conform to Islamic principles because the rate of return is meant to be tied to each transaction, rather than to the time dimension. However, some Muslim scholars advocate a stricter utilization of such modes.

Source: Kazarian, 1993; Iqbal and Mirakhor, 1987; Errico and Farahbaksh, 1998.

un-Islamic way, meaning that the lease payments must be agreed on in advance to avoid any speculation.

As with Murabaha transactions, there will be concerns relating to the Islamic institution's ownership of real property, disclaimers of warranties, the application of strict liability and the enforceability of a fixed payment upon default. The loss and destruction risks generally remain with the lessor, unless caused by the negligence or default of the lessee. Although insurance is an option for western lease financing, there may be issues as to whether insurance in this context is acceptable under Islamic law. The lessee should start making lease payments only after the leased asset has actually been delivered to him (her). In addition, if the leased asset were destroyed, the lessee would cease making payments to the lessor. This practice is contrary to the practice in most western lease financing where the lessee continues paying rent even if the property is destroyed.

Islamic leasing has also been criticized for being a complicated concept with a limited scope for business. However, the product is becoming the most popular form of Islamic finance. The products involved in Islamic leasing run the standard gamut from European oil refineries to medical equipment in the United States. Western banks offering Islamic instruments, such as Citicorp in the USA and Kleinwort Benston in London are now more active in Islamic leasing, and the leasing funds have been raised from both Muslim and non-Muslim investors (Collett 1995). Many investors, especially Islamic banks, have been attracted to leasing by the promise of higher yields than Murabaha (trade finance), which accounts for the bulk of Islamic banking activity. In addition, since Islamic leasing has the advantage of dealing with tangible assets, it has escaped the kind of criticism given to other Islamic products. This suits the Islamic finance ethos, and as investors move towards providing medium-term and long-term financing, the interest in Islamic leasing will increase.

Istinsa

Istinsa is a pre-delivery financing and leasing structured mode that is used mostly to finance long-term large-scale facilities involving, for example, the construction of a power plant. The Islamic institution could either own the plant, charge the lessee (project company) a fee based on profits, or sell the plant to the project company on a deferred basis with a profit mark-up similar to a Murabaha transaction. Unlike a Murabaha transaction, however, certain expenses that cannot easily be reflected in a sale and purchase agreement can be included in the fees to be paid to the Islamic institution by the project company.

Legal issues relating to Istinsa include whether under local law the Islamic institution can own real property and whether the concession or other rights

granted to the project company can be assumed or used by the Islamic institution.

Although the Islamic mark-up contracts (Murabha, Ijara, Ijara Wa-Iktina, and Istinsa) are widely used, their acceptability under Islamic law is disputed because they can imply a fixed return on investment for the financing financial institutions. Many Islamic scholars have suggested that mark-up contracts, while permissible, should still be restricted or avoided out of fear that these mark-up contracts may open a "back door" to interest (Siddiqi, 1983, and Khan 1987).

Some researchers also argue that there is a formal equivalence between markup contracts and debt, but the equivalence is not based on the payment of interest (Aggrawal and Yousef 2000). They argue that the salient feature of debt as described in the debt literature (Hart and Moore 1998) is that it transfers control of an asset to the debt holder in case of default. The main feature of mark-up instruments is that the financial institutions retain ownership of the asset and can seize it in cases of default. Thus, the control rights of mark-up contracts are equivalent to the control rights of debt instruments. However, there is a major advantage of Islamic mark-up contracts over Western debt contracts. In cases of default on an Islamic mark-up contract, there is no ambiguity about control of the assets. The financial institution retains title to the asset until the agent makes all payments. On the other hand, most defaulting western debt instruments triggers bankruptcy proceedings while the agent continues to control the asset. The delays induced by formal bankruptcy proceedings in the shift of ownership of the asset may introduce bargaining problems that can significantly decrease the efficiency of the investment. These problems are avoided when Islamic mark-up instruments are used.

Mudaraba

Mudaraba is a trust based financing agreement whereby an investor (Islamic bank), entrusts capital to an agent (Mudarib) for a project. Profits are based on a pre-arranged and agreed on ratio. Mudaraba agreement is akin to Western-style limited partnership, with one party contributing capital while the other runs the business, and profit is distributed based on a negotiated percentage of ownership. In case of a loss, the bank earns no return or a negative return on its investment and the agent receives no compensation for his (her) effort.

Musharaka

Musharaka is similar to a joint venture, whereby two parties (an Islamic financial institution and a client) provide capital for a project which both may manage. Profits are shared in pre-agreed ratios but losses are borne in

proportion to equity participation. It conforms to the principle of profit and loss sharing and it is suitable for long-term project financing; hence, it is considered to be the purest form of Islamic finance. Musaraka financing is closer to a traditional equity stake with rights of control.

In addition to mark-up and profit sharing instruments, two more Islamic instruments are used in futures trading, Bai-Salam and Bai-Muajjal. In a Bai-Salam contract the buyer pays an agreed on price in advance for commodities that will be delivered at a future date, while in a Bai-Muajjal deal, the seller allows the buyer to pay at a future price in either lump sum or installments. The fixed price can be the same or higher or lower as the spot price.

As part of their mission, Islamic financial institutions are encouraged to make charitable loans (Qard Hassan) to individuals or organizations. These loans are called Qard Hassan, or social benevolent loans, and do not carry an interest charge or mark-up. However, the borrower may willingly return the loan with a small mark-up. These are clearly negative net present value investments to Islamic banks and are not very common in most Islamic countries.

Recently a new Islamic mutual insurance type of fund (Takaful) has been introduced. Participants pay installments into a fund and the bank acts as managing trustee. In addition, a new Islamic banking product was tested in the European market at the end of 2000. The product is an equity Repo, which is similar to a Murabaha or cost plus profit transaction (Brooks, 1999). The typical maturity of the Islamic equity Repo is three months. The equity Repo is the product of collaboration between Cedelbank (a leading provider of global Repo services) and a major European bank in London.

IV. HISTORY AND GROWTH OF ISLAMIC BANKING

Islamic banking has established itself as an emerging alternative to conventional interest-based banking and is expanding rapidly over the last two decades in both Muslim and non-Muslim countries. No accurate figures exist as to the actual extent of Islamic investment market, but according to Citibank, in Bahrain, funds under Islamic financial institutions management are growing at an annual rate of 15 to 20 percent per year. Some Islamic banking sources suggest that the total value of Islamic funds management may well be over $200 billion. In the past two decades, Islamic banks have recorded high growth rates both in size and number around the world. Islamic banks operate in over sixty countries, most of them in the Middle East and Asia. In three countries, Iran, Pakistan, and Sudan, the entire banking system has been converted to Islamic banking. In other countries, the banking systems are still dominated by conventional banking institutions operating alongside Islamic banks. Now there is a move away from the Middle East and Asian areas and a desire to

spread the risk. There is a diversification trend towards the United States and Europe.

Islamic banking is the fastest growing segment of the credit market in Muslim countries with Islamic banks. The market share of these banks has risen from 2 percent in the late 1970s, to about 15 percent in the mid 1990's, as measured by assets in the banking system (Babai 1995). Conventional commercial banks have also started to offer Islamic financial contracts. Islamic banking is becoming stronger industry and is not just a niche financial services industry, but a niche market. Many bankers predict that Islamic banking could be responsible for management of over 50% of savings in the Islamic countries in the next decade. Global financial institutions have recognized this trend and are capitalizing on the attractive niche market. Some of the western banks that have established dedicated Islamic banking subsidiaries or have substantial dealings in the field include, Citibank, Bank of America, Commerzbank, Deutche Bank, Merrill Lynch, ABN AMRO, BNP Paribas, Pictet & Cie, UBS, Standard Chartered, Barclays, HSBC, Royal Bank of Canada, American Express, Goldman Sachs, Kleinwort Benson, ANZ Grindlays and Flemings. A growing number of western investment companies are now offering Islamic investment products to interested Islamic investors worldwide. However, despite the advances by western banks and investment companies, the mainstays of Islamic investments continue to be the Islamic banks themselves.

Calculating the exact size of the Islamic banking sector is difficult. Pakistan, for example, defines all of its financial institutions as Islamic even though western bankers say that many of the transactions are still effectively conventional banking. Saudi Arabia, on the other hand, does not formally admit the distinction between conventional and Islamic banking. Some Islamic bankers suggest that the number of banks that offer Islamic products around the world total over 250. The asset size of Islamic banks has also experienced a high growth rate. Today many Islamic banks are among the largest banks in their respective countries (Kazarian 1993 and Ray 1995).

In terms of service, the most dramatic change in approach has come in the past five years. In the past, Islamic institutions were seen merely as a place for those with strong Islamic convictions to place their money. Today, senior managers of Islamic banks believe they must compete on commercial grounds by offering a more cost-effective financial package to non-Islamic as well as Islamic customers. The main factor fueling the dramatic growth is the spread of the Islamic religion globally. Islam is the fastest growing religion in world, and Muslims are increasingly searching for financial instruments that adheres to the their principles. Some non-Muslims are also participating in Islamic banking because they consider it to be commercially sound (Brooks, 1999).

Traditionally, specialized Islamic banks have been well positioned to attract deposits from Muslims and non-Muslims, but these institutions have generally lacked the technical ability to invest efficiently. This gap has been bridged by

the services of Western banks that swiftly and efficiently deploy funds into Islamically acceptable channels. This has often meant lower returns for Islamic investors due to the second layer of inter-mediation. However, this trend is changing. Islamic banks are becoming resourceful and are going global, in part due to their increased integration with international markets. At the same time, being aware of the potential of Islamic markets, Western banks are reaching out to investors directly and eliminating the middleman (the Islamic banks or Islamic windows of banks) in Muslim countries.

Advocates of Islamic banking argue that many Islamic banks operate according to the profit and loss sharing principle and that the profit-sharing contracts (equity) are the superior financial security to debt for many reasons including the risk-sharing properties of equity (Ebrahim and Safadi 1995). They also argue that by providing long-term financing to growth oriented-sectors of the economy, Islamic banks will promote growth in the Islamic countries (Chapra 1992, and Siddiqi 1983). Conversely, a few recent studies, argue against these two views. Aggarwal and Yousef (2000) suggest that most of the financing provided by the Islamic banks they examined in their study do not conform to the principle of profit-and-loss sharing. Instead, much of these financing activities are offered through debt-like instruments. Aggarwal and Yousef also found that Islamic banks rarely offer long-term financing to entrepreneurs seeking capital. This finding is also supported by Metwally (1992), and Pourian (1995). The two studies provide evidence that the maturities of Islamic financing contracts offered by Islamic banks in Egypt and Iran during the 1980's are mostly short (one year) or middle term (2-5 years). Few of the contracts have longer than 5 years maturities.

The activities of Islamic banks tend to reflect the conditions of the country in which they are based. There are strong retail operations in Iran (though they have played comparatively small role in international markets) and Saudi Arabia. In the more secular societies of northern Africa, Islamic banks compete on the quality of their products, not their religious acceptability. In Kuwait, well-established Islamic financial institutions have been involved in substantial financing for the petroleum sector and real estate investment and in the UAE the emphasis is on trade finance. In Iran, Islamic banks invest in entrepreneurial projects in economic sectors that are typically viewed as growth oriented such as agriculture (Kazarian (1993) and Saffari (1995)). Bahrain, on the other hand, has enjoyed some success in marketing itself as the region's Islamic financial center because of its internationally respected regulatory system. In Bahrain, there is a greater emphasis on investment banking. However, more competition with international banks is expected in the future. There is a gradual change as more Islamic institutions become aware of the opportunities in local markets and around the world. They are no longer looking at providing funding but they also want to play a major role in the transactions.

V. ISLAMIC BANKING AND FINANCE EXPERIENCES IN PAKISTAN, IRAN AND SUDAN

Islamic banking has thus far made substantial progress worldwide even though the niche that it has been able to create for itself in the total volume of international, or even Muslim world, finance is very small. The volume, however, is not important, but rather the respectability that the interest-free financial intermediation has attained and the positive evidence that it has provided about the workability and viability of this system. While in the 1950s and 1960s Islamic banking was only an academic dream of which few people were aware even among educated Muslims, it has now become a practical reality. It has also attracted the attention of Western central banks like the Federal Reserve Board and the Bank of England, along with international financial institutions like the IMF and the World Bank, and prestigious centers of learning like Harvard and Rice Universities in the United States and the London School of Economics and Loughborough University in the United Kingdom. It has also received favorable coverage in the Western press. Prospects for the future are expected to be better, particularly if the instability that now prevails in the international financial system continues to accentuate and leads to a realization that the instability cannot be removed by making cosmetic changes in the system but rather by injecting into the financial system greater market discipline of the type that the Islamic financial system stands for.

Islamic banking, as an institution, has only been around for 25 years but that is not to say that interest-free banks have not been tried before. There was one in Malaysia in the mid-forties and another in Pakistan in the late-fifties. Neither survived. In 1962, the Malaysian government set up the "Pilgrim's Management Fund" to help prospective pilgrims save and profit. The savings bank established in 1963 at Mit-Ghamr in Egypt was very popular and prospered initially, although it closed down for various reasons. However, this experiment led to the creation of the Nasser Social Bank in 1972. Even though the bank is still active, its objectives are more social than commercial.

The early seventies, on the other hand, saw the institutional involvement. The Conference of the Finance Ministers of the Islamic Countries held in Karachi in 1970, the Egyptian study in 1972, First International Conference on Islamic Economics in Mecca in 1976, and the International Economic Conference in London in 1977 were the result of such involvement. The involvement of institutions and governments led to the application of theory to practice and resulted in the establishment of the first interest-free banks. The Islamic Development Bank, an inter-governmental bank established in 1975, was born of this process.

The first private interest-free bank, the Dubai Islamic Bank, was also set up in 1975 by a group of businessmen from several countries. Two more private banks were founded in 1977 under the name of Faisal Islamic Bank in Egypt

and Sudan. In the same year, the Kuwaiti government set up the Kuwait Finance House. Twenty-five years since the establishment of the first Islamic bank, more than 250 Islamic financial institutions have come about. Although most are in Muslim countries, there are some in Western Europe, North America, and Asia.

Islamic banks have come a long way in a relatively short time and have captured a significant market share from their conventional rivals. Some of the penetration rates of Islamic banking services in Muslim countries are 5% in Malaysia, 12% in Saudi Arabia, and 30% in Kuwait. It is anticipated that the Islamic banking industry will be responsible for managing at least 40-50% of the total savings of Muslims worldwide in 8 to 10 years. It is important to note that Islamic banks tend to focus on their local markets while western institutions such as Merrill Lynch target the high-net-worth segment. There are no real global players in the field. There are no retail Islamic banks in OECD countries. Also, Islamic banks do not have the in-house expertise to develop Sharia-compliant products and thus, seek financial engineering expertise from western institutions.

Although most of the countries under discussion have different Islamic backgrounds, they all have been major players in revolutionizing Islamic financial institutions. The pioneers of full Islamization were Pakistan, Iran, and Sudan. Pakistan's Islamic banking concept began as early as in the 1950s when economists were keen on the ideology of Islamic banking. It was the first country to embark upon a full Islamic financial system. Pakistan had been persistent in making this concept work through change and reaffirming measures to achieve its goals. However, twenty years later, the picture had changed when the leaders realized that the country's inherent British system could not be changed. Pakistan was trying to change too much too quickly. A relatively young country, Pakistan was still under the influence of British legacy, the mist of its independence and freedom.

The first phase of the economic reform in Pakistan began in 1979 when Zakat was levied on all savings accounts in various kinds of banks. However, this method did not prove effective. Those who opposed declared that it was not Islamic to distribute Zakat through banks that are not the custodians of the money. Another objection was whether the money actually goes to the deserving or not, and its effectiveness in alleviating poverty.

Pakistan was the first country to revive the institution of Hisbah, the office that controls the markets, which provides municipal services and settles disputes. In the second phase of its Islamization, the Pakistani government outlawed interest and introduced 'brotherly and godly' ways of generating profits. Ironically, despite these local measures, foreign banking transactions were still working on western systems. The government was caught in its own web of conflicting cultures. The problem was further enhanced when it was pressured by international organizations like IMF to privatize its banking system. The system lacked planning. The matter got worse in 1992 when the

Federal Shariah Court declared that interest based banking is not Islamic and therefore should be banned. Finally, in 1998 it decided to eliminate riba from its banking system.

Pakistan's model teaches us that interest free banking employing PLS as a means of earnings is non-functional when 90% of the transaction is locked in mark up. It also raises the question of Islamic moral hazard with many businessmen who were taking advantage of the new banking model. This experiment therefore did not achieve its desired result.

Foremost on Iran's revolution was its desire to achieve economic independence, break up the Shah's economic policies and resolve the ideological struggle between the conservative and free market. A country that was exploited by western leaders was still injured by its shadows. The country was again divided into two major groups, with one for the Shah and one against. These conflicts were also translated into the economic scenario where one group was pro communist while the other was in favor of a laissez faire. Early financial transformation started when all banks were nationalized and taken over by Islamic foundations. Later political turmoil (Iran/Iraq war) led to the centralization of the command economy, where allocation of goods, price controls, and rationing were in the hands of the authority. By the late 1980s, the country went to great lengths to implement constitutional and institutional changes, which indicated that all forms of foreign loans, investments and participation were forbidden so that the government agency or company is not allowed. This changed, however, when the Soviet Union entered the market and a number of ethnic groups saw the benefit of ties with other countries such as Turkey, Saudi Arabia and the US. Financial policy then was revolutionized to accommodate these countries. Over the next few years, the 1983 Usury free Banking Act, began to fade in the face of merger movements. Foreign credits and exchange were available through banks but subjected to regulation of central banks. This model also failed because by eliminating riba from the financial system the country had created a worse condition through its informal relationship with external financial communities. This area was uncharted and gauged higher interest rates. There was not tight regulation to conduce the Islamic financial model.

The largest country in Africa, Sudan, became independent in 1956. It holds a culturally diversified population of Muslims and Christians and was also under Egyptian influence. It proclaimed Islamization in 1983. A guideline for banking systems was outlined and taxation was also included in this act. The entire banking system took a new turn in 1983 when it was fully Islamized and interest was outlawed. Another political wave hit the country and again the Islamic model failed.

The Malaysian Islamic system is different than the other three models because it does not attempt to fully dissolve conventional banking. In fact, both systems work together. It focuses its goals towards harnessing information technology to enhance efficiency. A country that is diverse with Chinese,

Indian, Malays and Muslims has always dominated the scenario due to the pact they signed at the time of independence in 1957. One of the factors showing that the financial system is working efficiently is their National Economic Policy. This model is revised each decade to ensure the transformation has not hindered its progress.

The Malay Islamic model incorporated Islamic banking into the financial system and harmonized it with the western practice. This is because an Islamic system should be recognized as a tool for effective financial practice. This smooth implementation is probably the result of Malay's tolerance of other traditions and nations. Unlike other countries, Malay had not attempted to fully Islamize its institutions.

The authority promoted its Islamic banking by setting up institutions that operated on Islamic principles. By making credit instruments like bills and bonds Islamic, it opened up a new channel of innovative products for its customers who were previously attracted by Islamization but reluctant to try it again. Universities and research centers were opened up to inform and educate the country of this new method of financing. The result was surprisingly positive both from the Western investors as well as the East.

Offshore financing centers are the key for convenience in conventional banking. Islamic banking in the Middle East, however, had other motives when they stepped into Islamic Financing. They modernize by integrating new policies for the region's economy. Bahrain is one such example where the small Gulf State used its diversity policy to change its focus from oil business to financial services. It leverages a number of competitive advantages due to geographic location, well-developed infrastructure, defined legal system and liberal trade.

The international financial community is impressed and attracted to Bahrain because of its regulatory system that imposes Basle capital ratios, maintaining average capital asset ratio and a mandatory eight percent ratio. It also follows the International Accounting Standards, meaning published financial statements. This opens them up to stocks, bonds and provides international trade related services. It is perhaps one of the best offshore models of Islamic banking when the Bahrain Monetary Authority had Shariah advisers to help with auditing, regulating, and developing short-term financial instruments that would provide liquidity for Islamic financial products.

VI. ISLAMIC BANKING AND FINANCE: PRELIMINARY ASSESSMENT

Historical Performance

Due to a number of historical circumstances, the Muslim world lost its technological and economic vitality. Consequently, a number of Islamic institutions, including the Islamic system of financial intermediation, became dis-

placed by Western institutions. However, the independence of Muslim countries has led to the revival of Islam and there is a longing to gradually reinstate most of the lost institutions, the Islamic financial system being one of them.

Two approaches have been adopted by Muslim countries for eliminating interest from their financial systems. Three countries, Pakistan, Iran and Sudan, have opted for the removal of interest from the operations of all their financial institutions simultaneously. In contrast, a number of countries, including some that are non-Muslim, have allowed the establishment of Islamic banks alongside of conventional interest-based banks. According to data collected by the International Association of Islamic Banks (IAIB), there were more than 176 financial institutions in the public and private sectors of both these groups of Muslim and non-Muslim countries by 1997 (see Table 2, Section A). They had a capital of $7.3 billion and reserves of $3.1 billion. Their assets and deposits amounted to 147.7 billion and $112.6 billion respectively.

During 1997, these institutions made a net profit of $1.2 billion. The ratio of their net profit to capital and assets was 23.1 and 1.2% respectively. While most variables have registered a relatively high rate of growth, their capital and reserves have not kept pace. They rather declined to 7% of their assets (unadjusted for their riskiness) in 1997 from 9.5% in the previous year. This may perhaps have been partly due to the East Asia crisis, which adversely affected nearly all financial institutions around the world.

Of the 176 institutions, 9 were in Europe and America, 47 in the Middle East (including 21 in the GCC countries), 35 in Africa, and 82 in Asia (of which 31 were in South East Asia and 51 in South Asia) (see Table 3). In addition, there were a number of banks, which had not yet become members of IAIB. Moreover, the IAIB database does not include the rapidly expanding deposits accepted by a number of conventional banks on the Islamic basis and also the Islamic mutual and index funds marketed by both Islamic and conventional banks (Chapra and Khan, 2000).

Comparison of Islamic and Conventional Banking Frameworks

Table 4 provides a synoptic comparison of Islamic and conventional banking frameworks. There are several points that are worth noting. First, Islamic banks guarantee neither the capital value of nor the return on investment deposits, and these banks basically pool depositors' funds to provide depositors with professional investment management. This situation underscores an interesting similarity between the operation of Islamic banks and investment companies in the West. There is, however, a fundamental difference between the two that needs to be recognized. It lies in the fact that investment companies sell their capital to the public, while Islamic banks accept deposits from the public. This implies that shareholders of an investment company own a proportionate part of the company's equity capital and are entitled to a number of rights, including receiving a regular flow of information on develop-

Table 2: Growth of Islamic Financial Institutions (000 US $)

A. Aggregate Size Year-wise

Year	No. of Banks	Combined Capital	Combined Assets	Combined Funds under Management	Combined Reserves	Combined Net Profits
1993	100	2,390,259	53,815,280	41,587,332	N/A	N/A
1994	133	4,954,007	154,566,911	70,044,222	2,383,413	809,076
1995	144	6,307,816	166,053,158	77,515,832	2,918,995	1,245,493
1996	166	7,271,003	137,132,491	101,162,943	5,745,765	1,683,648
1997	176	7,333,079	147,685,002	112,589,776	3,075,526	1,218,241

B. Sector Financing (In Percentage of total Financing)

Year	Trading	Agriculture	Industry	Services	Real Estate	Others
1993	30.5	13.3	30.1	11.4	N/A	14.7
1994	26.96	13.32	27.54	14.79	5.44	11.96
1995	29.81	8.53	18.91	13.1	12.1	17.13
1996	31.17	7.5	18.82	13.17	11.67	17.67
1997	32	6	17	12	16	16

C. Modes of Financing (Percent of Total Financing)

Year	Murābahah	Mushārakah	Mudārabah	Ijārah	Others
1994	41.54	8.17	12.56	8.70	26.79
1995	45.58	8.72	15.25	9.72	21.06
1996	40.30	7.20	12.70	11.50	28.30
1997	37.00	19.00	6.00	9.00	29.00

Source: International Association of Islamic Banks (1997); Chapra and Khan, 2000.

ments of the company's business and exerting voting rights corresponding to their shares on important matters, such as changes in investment policy. Hence, they are in a position to make informed investment decisions, monitor the company's performance, and influence strategic decisions. By contrast, depositors in an Islamic bank are entitled to share the bank's net profit (or loss) according to the PLS ratio stipulated in their contracts. Investment deposits cannot be withdrawn at any time, but only on maturity and, in the best case, at par value. Moreover, depositors have no voting rights because they do not own any portion of the bank's equity capital. Therefore, they

Table 3: Growth by Region
Summary of Financial Performance (In thousands of US$)

REGION	NO. OF SHARES	%	CAPITAL		TOTAL ASSETS		DEPOSITS		RESERVES		NET PROFIT	
			Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
South Asia	51	29	884,048	12	39,272,976	26	25,664,913	23	1,077,163	35	249,792	20
Africa	35	20	202,197	3	1,573,846	1	730,025	1	82,087	3	19,750	2
S.E. Asia	31	18	149,837	2	2,332,204	2	1,887,710	2	160,136	5	45,659	4
Middle East	26	15	3,684,136	50	83,136,100	56	69,076,443	61	382,286	12	252,185	20
G.C.C.	21	12	1,787,395	24	20,449,637	14	14,088,581	12	1,353,167	44	603,642	49
Europe/America	9	5	616,795	0	908,922	1	1,139,541	1	20,613	1	66,707	5
Asia	2	1	3,452	0	5,727	0	2,563	0	24	0	282	0
Australia	1	0	5,219	0	5,590	0	N/A	0	50	0	224	0
TOTAL	176	100	7,333,079	100	147,685,002	100	112,589,776	100	3,075,526	100	1,238,241	100

Source: International Association of Islamic Banks (1997).

Table 4: Comparison of Banking Frameworks

Characteristics	Paradigm Version of Islamic Banking	Conventional Banking
Nominal value guarantee of: Demand deposits	Yes	Yes
Investment deposits	No	No
Equity-based system where capital is at risk	Yes	No
Rate of return on deposits	Uncertain, not guaranteed	Certain and guaranteed
Mechanism to regulate final returns on deposits	Depending on banks' performance/profits from investments	Irrespective of banks' performance/profits from investments
PLS principle is applied	Yes	No
Use of Islamic modes of financing: PLS and non-PLS modes	Yes	N/A
Use of discretion by banks with regard to collateral	Possible for reducing moral hazard in PLS modes[11] Yes in non-PLS modes	Yes always
Banks' pooling of depositors' funds to provide depositors with professional investment management	Yes	No

Source: Errico and Farahbaksh (1998).

cannot influence the bank's investment policy (as noted, their relationship with the bank is regulated according to an *unrestricted Mudaraba* contract, see table 1). Second, because of the structure of their balance sheets and the use of profit and loss sharing arrangements, banks operating according to a paradigm version of Islamic banking appear to be better poised than conventional banks to absorb external shocks. Indeed, as noted previously, these Islamic banks have the ability to reduce the capital value of investment deposits in the case of loss. Third, Islamic banks are not expected to reduce credit risk by systematically requiring collateral or other guarantee as a pre-requisite for granting PLS facilities. Fourth, a critical difference between the two-permissible systems of operation needs to be recognized. Islamic banks can use all of their deposits (demand and investments) for their financing and investment activities in Scheme A, while only investment deposits can be utilized for such purposes in Scheme B. This makes Scheme A, where banks' assets and liabilities are fully integrated far riskier than Scheme B, where

banks' liabilities are divided in two windows. Indeed, in Scheme A, given the fact that (1) demand deposits are guaranteed in capital value and are redeemable by the depositors on demand; (2) demand deposits can be used to finance risk-bearing investment projects; and (3) there is not a mandated specific reserve requirement on demand and investment deposits, an assets-liability mismatch can occur, leading possibility to negative net worth, or bank insolvency. (Errico and Farahbaksh, 1998).

Islamic Mutual Funds

Shariah based investing incorporates seven main pillars that work together to deliver competitive performance and to promote socially and ethically responsible business practices, which in turn, contribute to improvements in the quality of life throughout society.

a. *Shariah Supervision* by a qualified Shariah supervisory board is an integral component of any serious Islamic equity fund structure. The board is typically made up of prominent scholars, and well versed and disciplined in Shariah, particularly in the areas of transactions and business dealings. The board should be independent and should act in an advisory and supervisory role with the fund's management and assist in the development of fund management policy, Shariah screens, investment strategy, implementation, monitoring and reporting.
b. *Screening* is the practice of including or excluding publicly traded securities from investment portfolios or mutual funds based on the religious and ethical precepts of the Islamic Shariah. Generally, Muslim investors seek to own profitable companies that make positive contributions to society. Certain businesses are incompatible with Shariah laws. Therefore, stocks of companies whose primary business is not permissible according to Shariah are excluded, such as: companies that receive a major portion of their revenues from alcohol, tobacco and pork related products; interest based financial institutions such as banks, brokerage and insurance companies; and entertainment companies, including most hotels, gaming, pornography and music. In addition, most of the Shariah screens currently in use by fund managers include three financial-ratio filters:
    1. Excluding companies if total debt divided by total assets is equal to or greater than 33%.
    2. Excluding companies if accounts receivable divided by total assets is equal to or greater than 45%.
    3. Excluding companies if non-operating interest income is equal to or greater than 5%.

c. *Purification* is the process of eliminating or cleansing the portfolio from income or gain resulting from interest (*Riba*) or other impure revenue sources. The fund should have a strict, quantifiable formula and methodology of separating interest related and impure income from the portfolio, including dividends and capital gains.
d. *Charity/Zakah*: Impure portfolio income is donated to charities and non-profit organizations with the conditions that the monies are not used to build a mosque or print the Koran. The matter of calculating Zakah is complicated in equity portfolios due to the timing of portfolio income and capital gains. Zakah calculations may be provided through the accounting process of the fund for investors. Tax deferred or exempt arrangements, as well as trusts, further complicate this. Nonetheless, Shariah Supervisory Boards may be asked to suggest guidelines that may then be incorporated into specialized software. Zakah payments may be administered and directed to the same organizations receiving donations and charity from impure portfolio income and may be used for any good purpose.
e. *Shareholder Advocacy* describes the actions many socially aware investors take in their roles as owners of public corporations. These efforts include dialoging with corporate management on issues of concern, and submitting and voting proxy resolutions. Socially responsible proxy resolutions are generally aimed at influencing corporate behavior and practices toward a more responsible level of corporate citizenship.
f. *Monitoring and Reporting* involves a process of vigilance over the fund's holdings to ensure compliance with the Shariah filters, fund strategies and policies. A screened portfolio is only the first step towards Shariah compliance. Shariah compliance is an ongoing process and requires diligent analysis of company financial statements, practices and revenue sources. Ongoing management and shareholder reports are necessary to provide fund principals and investors with timely information related to Shariah issues, the fund, its practices and performance.
g. *Community-Based Investment* programs provide capital to people and organizations that have difficulty attaining it through conventional channels or are under-served by conventional financial or lending institutions. Community Development Venture Capital (CDVC) funds for low- income housing and small business development in the United States and abroad may also be established. Community-based investments enable people to improve their standard of living, develop their own small businesses and create jobs for themselves and their neighbors. (Valpy, 2000).

Table 5 provides three-year historical returns of 37 Islamic Mutual Funds. From this table, we can ascertain that ethical investment does provide a very good return compared to regular mutual funds.

Table 5: Mutual Fund Performance Data

	Fund Name	Returns 1999	1998	1997	Return since Inception
1	Islamic Multi-Investment Fund	31.80%	3.90%	N/A	14.80%
2	GAM AIKawthar	24.87%	16.60%	−13.15%	6.70%
3	AIBaraka Global Equity	12.14%	24.60%	N/A	41.30%
4	Al Rajhi Global Equity	38.30%	17.13%	17.60%	88.05%
5	Al Rajhi Egypt Equity	0.48%	−14.01%	5.00%	−16.06%
6	Al Rajhi Local Share	14.01%	0.00%	−11.10%	−33.48%
7	Al Rajhi Middle East Equity	32.97%	0.00%	−11.10%	22.53%
8	Al Rajhi Small Companies	44.89%	N/A	N/A	44.89%
9	Al-Safwa International Equity	N/A	16.48%	−3.74%	16.75%
10	Tabung Ittikal Arab-Malaysian	45.53%	8.72%	−27.20%	28.55%
11	Amanah Saham Bank Islam	10.01%	−36.68%	N/A	−48.10%
12	Citi Islamic Portfolios A&B	54.95%	16.24%	10.60%	81.80%
13	Mendaki Global	52.10%	39.61%	−20.62%	29.40%
14	Mendaki Growth	55.30%	40.00%	−42.80%	12.60%
15	Amanah Saham Wanita (ASNITA)	41.53%	9.29%	N/A	51.00%
16	Miraj Global Equity	40.45%	16.57%	N/A	56.10%
17	Al Kawthar Fund	27.31%	13.00%	N/A	42.00%
18	Alfanar Investment Holdings	36.70%	13.20%	N/A	49.90%
19	Alfanar Essex Technology	102.70%	N/A	N/A	102.70%
20	Alfanar US Capital Growth	49.70%	N/A	N/A	49.70%
21	Alfanar US Capital Value	25.70%	N/A	N/A	25.70%
22	Alfanar Europe	18.10%	1.60%	N/A	18.10%
23	RHB Mudharabah	35.70%	53.33%	−32.81%	0.30%
24	Oasis International Equity	24.32%	10.80%	16.70%	N/A
25	SAMBA Global Equity	5.03%	N/A	N/A	5.03%
26	Amana Growth	99.42%	16.80%	4.46%	24.36%
27	Amana Income	8.68%	14.07%	23.62%	10.88%
28	Pure Specialist Fund	42.19%	26.24%	−24.93%	N/A
29	Alkhawarizmi Fund	1.67%	3.56%	4.00%	9.50%
30	Ibn Majid Emerging Markets	49.10%	−25.50%	2.32%	32.40%
31	TII Small-Cap Equities	87.29%	−8.12%	−1.89%	69.50%
32	Al-Dar Eastern Europe	33.34%	−40.10%	N/A	−20.13%
33	Al-Dar Europe Equities	24.26%	23.62%	N/A	53.61%
34	Al-Dar World Equities	47.23%	26.03%	N/A	85.67%
35	Al-Bukhari Global Equity	20.90%	6.10%	N/A	27.00%
36	Hegira Global Equity	31.00%	33.20%	N/A	N/A
37	ZAD Growth Fund LP	62.21%	N/A	N/A	68.28%

Source: Failaka International, Inc.

Dow Jones Islamic Index

Dow Jones Indexes has created a family of equity indices for people who wish to invest according to Islamic investment guidelines. The Dow Jones Islamic Market Indexes track Shariah Law compliant stocks from around the world, providing Islamic investors with comprehensive tools based on a truly global investing perspective. The Dow Jones Islamic Market Indexes currently include the DJ Islamic Market Index (DJIM), the DJ Islamic Market US Index (IMUS), the DJ Islamic Market Technology Index (IMTEC), the DJ Islamic Market Extra Liquid Index (IMXL), the DJ Islamic Market Canadian Index (IMCAN), the DJ Islamic Market UK Index (IMUK), the DJ Islamic Market Europe Index (IMEU), and the DJ Islamic Market Asia/Pacific Index (IMAP). (Dow Jones web site).

The Dow Jones Islamic Market Indices are constructed from the 2,700 stocks in the Dow Jones Global Indexes family, which means they are accessible to investors and are well traded. The DJGI methodology removes issues that are not suitable for global investing. The Dow Jones Islamic Market Indices include the most liquid securities meeting the Shariah investment criteria in the market, and reflect the industry breakdown of the global market. The Dow Jones Islamic Market Indices are capitalization weighted. The indices are calculated and disseminated to major market data vendors in real time. Index calculation is based on Laspeyres' formula; it does not include reinvested dividends.

Certain businesses are incompatible with Shariah Laws. Thus, stocks of companies whose primary business is in areas not suitable for Islamic investment purposes are excluded from the Dow Jones Islamic Market Index. Excluded products include: alcohol, pork related products, conventional financial services (banking, insurance, etc.), entertainment (hotels, casinos/gambling, cinema, pornography, music, etc.). Shariah scholars also do not advise investments in companies that produce tobacco and/or defense/weapons. These incompatible lines of business, represented by 18 of the 122 industry groups within Dow Jones Global Indexes, are removed from the "universe" of stocks considered for the Dow Jones Islamic Market Index. Other companies classified in other industry groups also may be excluded if they are deemed to have a material ownership in or revenues from prohibited business activities.

After removing companies with unacceptable primary business activities, the remaining universe is tested by three financial-ratio "filters." The purpose is to remove companies with unacceptable financial ratios. The filters are: 1. Exclude companies if Total Debt divided by Total Assets is equal to or greater than 33%. (Note: Total debt = Short-Term Debt + Current Portion of Long-Term Debt + Long-Term Debt); 2. Exclude companies if Accounts Receivables divided by Total Assets is equal to or greater than 45%. (Note: Accounts Receivables = Current accounts receivables + Long-Term Receivables); 3. Ex-

clude companies if the sum of Non-Operating Interest Income plus other impure income divided by Revenues is equal to or greater than 5%. Companies that pass these screens are included in the Dow Jones Islamic Market Index investable universe, from which index components are selected.

The Dow Jones Islamic Market Indexes are based at December 31, 1995. The base value is set at 1000. The Dow Jones Islamic Market Indices are reviewed quarterly, with component changes implemented on the third Friday of March, June, September and December. This frequency assures that the indices reflect the latest trends and developments in the global stock market. Table 6 provides performance measures of Dow Jones Islamic Index, which has been in operation for five years (1996-2000). Based on number of criteria, we can conclude that DJIM is performing at par with other broad-based market indices.

VII. CURRENT PRACTICES OF ISLAMIC BANKS AND REGULATIONS

Current Practices of Islamic Banking

Islamic banking in current practice diverges in several important ways from the ideal version. These differences can be summarized in four main points. First, all deposits, including investments, are always explicitly or implicitly guaranteed. In some cases, the capital value guarantee is formally written in laws and regulations; in other cases, it is based on implicit understanding among the authorities, banks, and the public. Second, The PLS principle is never strictly applied. There are various degrees of noncompliance with respect to the PLS principle in current banking practices. In some cases, the bank guarantees the expected rate of return on investment deposits. Moreover, this rate of return is de-linked from banks' profit. As a result, the expected rate of return for each type of deposit is the same for all banks, irrespective of banks' different levels of profitability. In other cases, the PLS principal is partially implemented through complex formulas aimed at maintaining the link between returns to financial assets and profits originating from banks' investment of deposited funds. However, central banks discourage large variations in the rates of return that banks are allowed to offer to customers in order to avoid destabilizing shifts in deposits. This is accomplished through the imposition of ranges (differentiated by sectors of the economy and nature of borrowers) within which banks and customers are allowed to bargain and agree on the terms of specific transactions. (Errico and Farahbaksh, 1998).

Third, financing is mostly carried out through non-PLS modes. On average, Islamic banks operate through the less risky, shorter-term non-PLS modes, notably: mark-up, leasing, and lease purchase transactions typically related to trade financing. The most recent available aggregate data indicate that, in 1996, non-PLS modes accounted for 72.2 percent (72.8 in 1995) of total utilized

Table 6: Performance Measures of DJIM (1996–1998)

Volatility	1996	1997	1998	History
DJIM	8.30%	13.40%	16.00%	12.94%
DJ US	11.47%	17.23%	19.70%	16.46%
DJ World	7.08%	12.39%	16.48%	12.56%
S&P 500	11.58%	17.82%	19.86%	16.76%
MSCI World	7.42%	12.78%	16.36%	12.71%
Returns	**1996**	**1997**	**1998**	**History**
S&P 500	20.26%	31.01%	26.67%	99.57%
DJ US	20.49%	31.69%	26.78%	101.17%
DJ World	10.99%	12.58%	20.22%	50.20%
DJIM	20.24%	18.79%	25.91%	79.84%
MSCI World	14.81%	20.76%	19.15%	65.21%
Sharpe Ratios	**1996**	**1997**	**1998**	
S&P 500	1.31	1.44	1.12	
DJ US	1.35	1.53	1.13	
DJ World	0.84	0.59	0.96	
DJIM	1.83	1.01	1.34	
MSCI World	1.32	1.21	0.90	

Annualized Tracking Errors 12/31/95 to 12/31/98	S&P 500	DJ US	DJ World	DJIM	MSCI World
S&P 500	—	0.62%	6.52%	4.73%	6.41%
DJ US	0.62%	—	6.30%	4.55%	6.18%
DJ World	6.52%	6.30%	—	2.76%	2.17%
DJIM	4.73%	4.55%	2.76%	—	3.17%
MSCI World	6.41%	6.18%	2.17%	3.17%	—

Correlation 12/31/95–12/31/98	S&P 500	DJ US	DJ World	DJIM	MSCI World
S&P 500	—	99.86%	82.01%	92.26%	83.91%
DJ US	99.86%	—	82.69%	92.52%	84.61%
DJ World	82.01%	82.69%	—	94.74%	96.62%
DJIM	92.26%	92.52%	94.74%	—	93.35%
MSCI World	83.91%	84.61%	96.62%	93.35%	—

lines of credit made available by the Islamic Development Bank to the forty-eight member countries to promote Islamic banking. (Islamic Development Bank, 1996). Fourth, there is discretion with regard to collateral. Islamic banks are allowed to use a degree of discretion in deciding if collateral is needed before granting their facilities, including the PLS modes of financing.

As a result of the above practices, the element of uncertainty needed to legitimize the bargain for possible profits has been substantially reduced and, in some cases, eliminated. Moreover, PLS modes of financing have been made similar to non-PLS modes through the reduction of their risk element. Therefore, it can be concluded that, for all practical purposes, Islamic banking is currently carried out in a *hybrid way* that is somewhere in between the paradigm version and conventional banking. The degree of divergence from the paradigm version is specific to each country where Islamic banking principles are followed and need to be assessed on a case-by case basis.

The more current Islamic banking practices diverge from the paradigm version, the more Islamic banks lose their distinctive features and tend to resemble conventional banks. Hence, supervisory standards and best practices developed by the Basle Committee on Banking Supervision become increasingly applicable to Islamic banks and should be implemented accordingly. Table 7 indicates how the shift from the paradigm version to current practices should affect the focus of banking supervision in an Islamic framework.

Table 7: Islamic banking in Practice: Shift in the Focus of Banking Supervision

Issue	Paradigm Version of Islamic Banking	Islamic banking in Practice 1
Robustness to absorb external shocks	Higher	Lower
1) Liquidity risks	Less likely	More likely
2) Insolvency risks	Less likely	More likely
Relative importance of:		
Assessment and management of operational risks:		
(1) Reliance on appropriate procedure and adequate infrastructure	Higher	Lower
(2) Reliance on human technical expertise.	Higher	Lower
Prudential standards	Relevant; to be assessed on a bank-by-bank and country by country basis	Crucial
Information disclosure requirements	Higher	Lower

1. Depending on the degree of divergence from the theoretical model. At the end of the spectrum, Islamic banking may coincide with conventional banking, except for the terminology. (Source: Errico and Farahbaksh, 1998).

Islamic Banking Supervision

Table 8 provides a summary of existing regulation of the OIC Member Countries. A thematic presentation of its salient features are given below.

Compliance with International Standards

1. Most member countries reviewed here have adopted the international standards, including the Basel Committee's Core Principles and minimum risk-weighted capital requirements and the International Accounting Standards Committee's international accounting standards.
2. Some countries are implementing crash programmers to adopt the international standards but report difficulties, particularly in the risk-weighting of assets created by the Islamic modes of finance. A few countries have not revealed the state of their compliance with international standards.
3. Compliance with the standards set by the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI), has not yet fully materialized; only two countries (Bahrain and Sudan) have so far explicitly adopted the standards set by it.
4. Since most Islamic banks are small, some countries have announced a program of mandatory merger of Islamic banks and strengthening of their capital to make them viable in an international environment, which has become characterized by mega-banks.
5. Three countries, Iran, Pakistan and Sudan, which have initiated the transformation of their entire economies in accordance with Islamic teachings, have announced major restructuring programs for their banking sectors. Each of the three countries have active plans for the privatization of banks. Pakistan and Sudan have announced a mandatory program for strengthening the capital of banks and of mergers to the extent to which this is necessary for the purpose. (Chapra and Khan, 2000).

Offsite and Onsite Supervision

1. Iran, Malaysia, Pakistan and Turkey have put in place both offsite and onsite supervision systems to realize the standard objective of such systems.
2. Malaysia follows the CAMELS rating system. The CAMELS rating system refers to capital adequacy, assets quality, management quality, earnings, liquidity, and systems for internal controls.

VIII. PROBLEMS AND CHALLENGES OF ISLAMIC BANKING AND MARKETS

Islamic financial markets are operating far below their potential because Islamic banking by itself cannot take root in the absence of the other

Table 8: Important Features of Islamic Banking and Supervisory Regimes in Muslim Countries

Country	Salient Features of Islamic Banking Supervisory Systems
Bahrain	Regulated by the Bahrain Monetary Agency (BMA) ♦ BMA regulates both commercial banks and investment banks (securities firms); insurance companies are under separate regulatory authority ♦ Dual banking (Islamic and conventional) banking system; Basel capital requirements and core principles adopted for both groups, ♦ Four Islamic banking groups: a) Islamic commercial banks, b) Islamic investment banks, c) Islamic Offshore banks, and d) Islamic banking windows in conventional banks ♦ Consolidated supervision ♦ International Accounting Standards adopted, ♦ Each Islamic bank must have a *Sharī'ah* board ♦ Compliance with AAOIFI standards under active consideration ♦ Investment deposits, current accounts and capital allocation for assets must be declared, ♦ Mandatory liquidity management by adopting the standardised maturity buckets of assets ♦ Islamic and conventional mixed system
Gambia	Regulated by the Central Bank of Gambia (CBG) ♦ Islamic banking law exists ♦ Dual system ♦ Separate *Sharī'ah* board required ♦ Compliance with Basel capital requirements and core principles and International Accounting Standards not clear
Indonesia	Regulated by the Central Bank of Indonesia (Bank Sentral Republik Indonesia–BSRI) ♦ Separate regulatory bodies for banks and securities firms ♦ Separate Islamic banking law does not exist; Islamic (*Sharī'ah*) banking is covered by added section in the banking law (Act No. 10 1998 and Act No. 23 1999) ♦ Separate *Sharī'ah* board required ♦ Islamic windows allowed ♦ Consolidated supervision ♦ Basel capital requirements and core principles adopted ♦ International Accounting Standards adopted ♦ Major financial transformation in process to strengthen bank capital and solvency ♦ Active *Sharī'ah* bank development strategy in place by the government
Iran	Regulated by the Central Bank of Iran (Bank Jamhuri Islami Iran) ♦ All banks in the public sector with a plan for minority privatisation ♦ Bank regulation and supervision is strongly effected by monetary as well as fiscal and other government policies ♦ Single (Islamic) banking system under the 1983 Usury Free Banking Law ♦ Modes of finance are defined by this Law ♦ Recent policy orientation towards adopting the Basel capital and supervisory standards and International Accounting Standards ♦ No *Sharī'ah* board for individual banks ♦ Onsite and offsite supervisory methods and objectives defined and applied ♦ Banks and insurance companies are supervised by different regulatory authorities

Table 8: (Continued)

Country	Salient Features of Islamic Banking Supervisory Systems
Jordan	Regulated by the Central Bank of Jordan (CBJ) ♦ Separate regulatory bodies for banks and securities firms ♦ Islamic banking law exists ♦ Dual system ♦ Separate *Sharī'ah* board required ♦ Consolidated supervision ♦ Basel capital requirements and core principles adopted ♦ International Accounting Standards adopted
Kuwait	Supervised by the Central Bank of Kuwait (CBK) ♦ CBK regulates both commercial banks and investment banks (securities firms); insurance companies are under separate regulatory authority ♦ Dual banking system ♦ Two Islamic banking groups: a) Islamic commercial banks, and b) Islamic investment banks. Conventional banks not allowed to have Islamic banking windows. ♦ Consolidated supervision ♦ Basel capital requirements and supervisory standards adopted ♦ International Accounting Standards adopted ♦ Separate Islamic banking law under active consideration ♦ Separate *Sharī'ah* board for each bank necessary
Malaysia	Regulated by the Central Bank of Malaysia (Bank Nagara Malaysia—BNM) ♦ Insurance companies and banks under same regulatory authority; securities firms under separate authority ♦ Private banks ♦ Dual banking system ♦ Islamic windows allowed in conventional banks ♦ Consolidated supervision ♦ Basel capital requirements and core principles adopted ♦ International Accounting Standards adopted ♦ CAMELS rating system adopted ♦ Onsite and offsite supervision well defined with clear objectives ♦ Separate *Sharī'ah* boards at institutional level in the BNM and Securities Exchange Commission ♦ Islamic money market and liquidity arrangement exists ♦ Ministry of Finance closely associated with the supervision of Islamic banks
Pakistan	Regulated by the Central Bank of Pakistan (State Bank of Pakistan-SBP) ♦ Securities firms, and Insurance Companies are regulated by separate regulatory bodies ♦ Major banks in the Public Sector; bank regulation and supervision effected by government policies ♦ Islamic banking law does not exist ♦ *Mudārabah* Companies Law exists ♦ *Sharī'ah* board concept does not exist ♦ Islamic banks are not identified distinctly ♦ Basel capital requirements and supervisory standards adopted ♦ Bank merger is on cards to strengthen capital ♦ Concept of onsite and offsite supervision exists ♦ Major financial transformation is called for by the Supreme Court of Pakistan to introduce Islamic banking and financial system; a Financial Services Transformation Committee has been established by the SBP.

Table 8: (Continued)

Country	Salient Features of Islamic Banking Supervisory Systems
Qatar	Regulated by the Central Bank of Qatar (CBQ) ♦ Dual banking and separate regulatory system ♦ No separate Islamic banking law exists ♦ Islamic banks supervised by special directives of CBQ ♦ Separate *Sharī'ah* boards for banks required ♦ Standardised transparency requirements for Islamic banks exist
Sudan	Regulated by the Central Bank of Sudan (CBS) ♦ Single (Islamic) system ♦ Islamic banking law in place ♦ Separate *Sharī'ah* boards for banks required, also the Central Bank has a *Sharī'ah* Supervisory Board ♦ Substantial public sector control; supervision and regulation is effected by other government policies ♦ Evolution of financial instruments underway ♦ Compliance with the capital adequacy and supervisory oversight standards of the Basel Committee not clear ♦ Major bank merger is planned to strengthen bank capital
Turkey	Regulated by the Central Bank of Turkey (Turkeyi Cumhuriyet Merkez Bankasi—TCMB) ♦ Banks and securities firms regulated by separate bodies ♦ Law about Special Finance Houses covers Islamic banks ♦ Dual system; no Islamic windows allowed ♦ Basel Committee capital adequacy requirements and supervisory standards recently introduced ♦ Major financial transformation underway ♦ Onsite and offsite supervision concepts and methods exist
UAE	Regulated by the Central Bank of UAE ♦ Islamic banking law exists ♦ Dual system ♦ Islamic banking windows allowed ♦ Separate *Sharī'ah* boards required ♦ Basel Committee capital adequacy requirements and supervisory standards in place ♦ International Accounting Standards in place
Yemen	Regulated by the Central Bank of Yemen (CBY) ♦ Islamic banking law exists ♦ Dual system ♦ Islamic banking windows allowed ♦ Separate *Sharī'ah* board required ♦ Major policies and standards set by the CBY are equally applicable to all banks ♦ Separate supervisory office for Islamic banks inside the CBY under active consideration ♦ Compliance with the Basel standards not clear

Sources: Compiled from Country Case Studies referred to in the bibliography, Babikir (1999) and Web Sites of respective central banks, also given in the bibliography, and Chapra and Khan (2000).

necessary components of an Islamic financial system. A number of limitations and challenging issues will have to be addressed before any long-term strategy can be formulated (Dudley 1998, and Naughton 2000).

First, a uniform regulatory and legal framework that is supportive of an Islamic financial system has not yet been developed. Existing banking regula-

tions in Islamic countries are based on the Western banking model. Further, Islamic financial institutions face difficulties in operating in non-Islamic countries owing to the absence of a regulatory body that operates in accordance with Islamic principles. The development of a regulatory and supervisory framework that would address the issues specific to Islamic institutions would further enhance the integration of Islamic markets and international financial markets. None of the sizable and organized financial centers can claim to be functioning in accordance with Islamic principles. In addition, while the stock markets in emerging Islamic countries such as Egypt, Jordan, and Pakistan are active, they are not fully compatible with Islamic principles. The stock markets in Iran and Sudan may come closest to operating in compliance with Islamic principles.

Second, there is a need for risk analysis and risk-management tools to provide agents with hedging instruments to hedge against the high volatility in currency and commodities markets, especially for Islamic banks in Western markets. Interest rates play a key role in managing liquidity, pricing risk and allocating credit. In the absence of interest rates, the risk manager in an Islamic bank faces a greater challenge than the risk manager of a similar size Western bank. In addition to this burden, Islamic banks are unlikely to benefit from a critical mass of similar institutions with which an Islamic interbank market can be developed, thus requiring Islamic banks to hold higher levels of liquidity than Western banks, with a consequent negative impact on their ability to compete.

Third, a need exists for sound accounting procedures and standards that are consistent with the Islamic laws. Western accounting procedures are not adequate due to differences in the nature and treatment of financial instruments. Well-defined procedures and standards are necessary for information disclosure, building investors' confidence, and monitoring. Well-established standards will also help the integration of Islamic markets with international markets. Islamic institutions also have a shortage of trained personnel who can analyze and manage portfolios, and develop innovative products according to Islamic financial principles. Only a limited number of Islamic institutions can afford to train their staff and deploy resources in product development.

Fourth, there is a lack of uniformity in the religious principles applied in Islamic countries. Since there is no universally accepted central Islamic religious authority, Islamic banks have formed their own religious boards for advice and guidance. Islamic banks have to consult their respective religious boards, or Shariah (Islamic law) advisors, to seek approval for each new instrument. Differences in interpretation of Islamic principles by different schools of thought may mean that identical financial instruments are rejected by one board but accepted by another. Thus, the same instrument may not be acceptable in all countries. Another problem is that many people do not understand Islamic banking. The basic principle is clear, that it is contrary to Islamic law to make money out of money and that wealth should accumulate

from trade and ownership of real assets. However, there does not appear to be a clear definition of what is or is not an Islamic banking product; nor is there a clear definition of an Islamic bank. These two problems can be addressed by forming a uniform council representing different schools of thought. The council will consist of religious scholars and banking scholars with international exposure. The role of the council is to define cohesive rules and to expedite the process of clearly defining and introducing new products

Fifth, another challenge that Islamic banks must also address is size. Many of the Islamic financial institutions are extremely small and cannot remain serious players in the Islamic market as it continues to expand and attract large international banks. In order to be competitive in a global sense, Islamic banks have to reach mutual understandings to merge or cooperate. They also have to take fundamental strategic decisions about the type of banks they wish to become. The areas of development might well be in specialization. For example, in Africa the focus might be on agriculture, and in Asia the focus could be on industrial and service sectors and on trade. In Europe and USA, capital and financial leasing could be their specialty.

Sixth, Islamic banks are excluded from the lender of last resort function in many traditional banking systems in Muslim countries. The only exception is Malaysia because it has an active interbank money market and an Islamic clearing system that is run by the central bank. It is in the process of setting up a liquidity management house to internationalize their system, which could ultimately develop into a lender of last resort. The central bank in the West traditionally stands behind the banking system to offer liquidity lending to banks if there is a shortage of funds in the system. Islamic banks may not be able to use this facility because of the interest payments due on the loans.

Seventh, classification of risk sharing funds placed with Islamic banks is a further difficulty. The fundamental issue is to judge if these funds are capital certain. If they were capital certain they would be defined as a bank deposit under Western banking laws. However, if they were defined as investments in a collective investment scheme, they are not bank deposits. The classification of these funds has implications for Islamic banks' capital requirements. In addition, regulators in Western countries can, and do argue that because Islamic banking is relatively new and because their assets are often long-term and illiquid, the Islamic banks should carry more, rather than less capital. For example, a new financial reform bill was recently introduced in Turkey. The bill is to bring the Islamic banks and other special finance houses under the same body of legislation as conventional interest-bearing banks (Gorvett, 1998). As a result, Islamic banks in Turkey are now expected to hold an extra 6 percent of liquidity in form of Treasury bills and to invest an additional 50 percent from their own capital. Islamic banks are also required to insure the investors' deposits.

Finally, the secondary market for Islamic products is extremely shallow and illiquid, and money markets are almost nonexistent, since viable instruments

are not currently available. The development of an interbank market is another challenge. The pace of innovation is slow. For years, the market has offered the same traditional instruments geared towards shortened medium-term maturities, but it has not yet come up with the necessary instruments to handle maturities at the extremes. The lack in liquidity-enhancing instruments eliminated a large segment of potential investors. However, more liquid instruments are emerging through securitization. Three types of Islamic funds are becoming more popular: equity, commodity, and leasing. Equity funds, the largest share of the Islamic funds market, are the same as conventional mutual funds but with an Islamic touch that requires a unique "filtration" process to select appropriate shares. The filtration process ensures that the mode, operation, and capital structure of each business the fund invests in are compatible with Islamic law, eliminating companies engaged in prohibited activities and those whose capital structure relies heavily on debt financing to avoid dealing with interest.

The future of Islamic equity funds is bright in part because of a new wave of privatization under way in Muslim countries such as Egypt and Jordan, and in high-growth Islamic countries such as Indonesia and Malaysia, where the demand for Islamic financial products is growing rapidly. Commodity and leasing funds are other forms of Islamic funds. Commodity funds invest in base metals. Leasing funds pool auto, equipment, and aircraft leases and issue tradable certificates backed by the leases. International and regional institutions are working with Islamic finance and are contemplating the introduction of derivative products and syndication to enhance project finance. While the introduction of derivative products is being cautiously studied, it is suspected that these incorporate interest and may also support speculative activities. Simple derivatives, such as forward contracts, are being examined because their basic elements are similar to those of the Islamic instrument of deferred sale. Project finance, which puts emphasis on equity participation, is another natural fit for Islamic finance.

IX. ISLAMIC STOCK MARKET: PROSPECTS AND CHALLENGES

Many Muslim countries or with a majority Muslim population such as Egypt, Jordan, Turkey, Kuwait, Bahrain, Saudi Arabia, Karachi, Lebanon, Iran, Indonesia and Pakistan have well established stock markets. These markets are Western style markets with practices and regulations that do not strictly adhere to Islamic Laws. Many of these markets are now attempting to apply Islamic principles to trading. Malaysia, on the other hand, has already made great progress towards establishing the necessary infrastructure to facilitate trading according to Islamic principles. Islamic brokerage houses and an Islamic stock index consisting of 170 stocks that trade on the Kuala Lumpur Stock Exchange were also established.

The development of an Islamic equity market brings forward a number of problems and challenges (Naughton 2000). One of the most difficult aspects of designing an Islamic stock market is the issue of Qimar (gambling). This concept covers speculation in the stock market, that is, buying and selling stocks solely for short-term gains resulting from uncertainty in the market. In Western markets, moderate levels of speculation are quite acceptable. Speculators keep the market more watchful of what is happening and their trading improves the liquidity in the market (Figlewski, 1979). The interaction of rational investors, who trade on "true" information relating to the stock, and speculators, who trade on "noise" help to keep the market efficient in a Western sense (Black, 1986). A number of issues relating to speculation need to be resolved before a fully functioning Islamic stock market can evolve. Related to speculation is the practice of arbitrage and short selling; neither is an acceptable practice. An arbitrageur seeks to obtain a risk free return with zero investment and a short seller borrows a stock from a broker in anticipation of price decline where he can then buy the stock back at a lower price. Both activities are unacceptable because of its association with gambling and excessive risk.

The creation of excessive uncertainty, or Gharar is another unacceptable practice related to speculation. Buying or selling stocks in a highly volatile market that would produce excessive risk in the transaction is not permitted. Both buyers and sellers should not transact business when the outcome of the deal is highly uncertain (Kazmi, 1994). However, stocks are risky and market participants are attracted to them because of the expected higher return associated with high risk.

Certain transactions that take the form of Ikrah are not permissible. This happens when one party to a trade imposing a contract on an unwilling party, or imposing conditions that are unacceptable to the other party (Kazmi, 1994). From a Western perspective it is difficult to see any problem in this regard. Market participants willingly buy and sell derivative securities (options and futures) on daily basis. They know in advance the terms and possible outcomes of such contracts. From an Islamic perspective this would not be a problem in the case of traditional stock trading. However, in the case of options this is not acceptable. The option contract implies that option buyers will exercise the contract only when it is beneficial to them, while being a potential loss for the seller. The very fact that the buyer can impose a loss on the seller may make such a contract unacceptable in Islam. In addition, the reality that the loss is related to a derivative position, and not to an identifiable transaction in goods or services, creates further difficulties.

Trading in derivatives also raises the question of hedging or insurance. Traditional Western style insurance is prohibited in Islam. Hedging using derivatives is a form of insurance. Investors may seek to protect their underlying investments by buying and selling options or futures. In addition, the derivative market depends on the interaction of speculators and hedgers and

therefore, also has an element of speculation, which is a form of usury in Islam.

Confidentiality and the use of superior information for gain are generally acceptable in a Western stock market, provided it is not privileged price sensitive information being used by insiders. Western markets typically treat insider trading as an illegal activity. Manipulation of stock prices, for instance through creating a false market in a stock, is also typically illegal in Western countries and is another aspect of exploitation that would be regarded as Riba in Islam.

Deregulation is a major feature of all Western financial markets. Markets are allowed to function with little or no government interference. In the case of stock markets, there is some intervention because of the need to protect investors from insider trades, price manipulators, excessive risk taking and other aspects of moral hazard (Ghon Rhee, 1992). The main argument in favor of deregulation is that it improves market efficiency. From an Islamic perspective, a broader definition of market efficiency is needed. A definition that is similar to the concept of social efficiency under which financial markets in general, and stock markets in particular, should be efficient in the sense that they support social justice, fairness and the well being of society (Samuels and Yacout, 1981). This is not a strong feature of traditional Western views of efficiency. Some would argue that stock markets actually create social inefficiency by encouraging unequal distribution of wealth. Rash speculation also creates systemic risk and can have a destabilizing effect on the economy. The Wall Street crash of the 1920s and the Stock Market crash of 1987 are examples of the threats that stock markets pose. The collapse of the Kuwait stock exchange in 1982, due to the failure of major speculators and their financiers, is an example of the dangers faced by Muslim countries when uncontrolled speculation is permitted. In addition to speculation, stock markets provide opportunities for insider trading. Such activities can have an adverse effect on moral standards and business ethics.

The lack of strong form information efficiency in the Islamic secondary market may also create difficulties. There would be no confidential information if markets were efficient in the strong form. Many firms in Islamic countries try to keep confidential certain aspects of their activities, while market analysts following stocks of these companies elicit this information through painstaking research. Institutional investors who have highly skilled analysts aim to profit from this information by trading ahead of the rest of the market. This leads to a form of information asymmetry, which is a potential problem when considering acceptable contracts in Islam.

Finally, the basic western financial securities such as common stocks, bonds and preferred stocks, create problems when they are utilized in an Islamic economy. The reason stems from a lack of clear Shariah (Islamic law) guidance on their acceptability. Common stocks are perhaps the simplest, yet there appears to have been little in the way of comprehensive examination of their

acceptability in modern Islamic society. Since common stocks closely adhere to the profit and loss sharing principle, it is difficult to fault common stock as an Islamic security. However, not all common stocks would qualify for trading on an Islamic stock exchange as we discuss below.

Bonds on the other hand, present problems if utilized by Islamic firms and made available to Muslim investors through the stock market. A traditional Western style corporate bond is likely to fail any test of acceptability because they are interest based, paying fixed interest payments and in event of default penalties are imposed on the borrower. Such penalties are deemed to be un-Islamic as they are close to usury, the principle reason for the prohibition of interest in Islam (Siddiqi, 1995). One possibility is to utilize loans in the form of Qard Hassan (benevolent loan). Although these loans are already in use on a small scale, their use on an ongoing large-scale commercial finance in banking is not feasible. The solution of Islamic debt securities is likely to lie in transforming traditional bonds into transaction based contracts. Murabaha or Bai Muajjal contracts can be used to create debt instruments tied to a particular transaction such as the purchase of an asset by a firm. Subscribers to a bond issue would first buy the asset then resell it to the borrower at a price higher than the original cost, and receive payment for the sale over a specified period of time. This transaction is basically a collateralized bond, where the bondholder retains the claim on title of the asset until maturity. Even such transactions have been challenged on the grounds that it has similarities to contracts with interest.

Preferred stock is a fixed income security that closely resembles traditional debt financing. Hence traditional Western style preferred stocks are also not acceptable. However, restructuring of preferred stock to give them more equity features is likely to be acceptable, provided the return to investor is not a fixed return on the original amount invested (Mohsin 1983). Preferred stocks could also be structured as a transaction contract discussed above.

Listings on the Islamic stock exchange and the type of activities that are permissible should be addressed also. Only companies operating in acceptable areas of business activities can be listed on the exchange. Activities such as gambling services, pork products and alcohol products are (Haram) expressly forbidden in Islam. However, there are a number of other activities that could be considered (Makruh) discouraged but not forbidden. There is merit in avoiding such activities but no wrongdoing being involved. Activities relating to environmental degradation may fall within this category. It is the role of Islamic funds managers and directors of Islamic stock exchanges to filter out those companies that are involved in Makruh activities. This practice is not new to investors in the U.S, where many investors are turning to ethical investment funds or socially responsible funds. The funds will not invest in stocks of companies that are involved in activities that are judged to be unethical or socially irresponsible. Pollution creation, association with gam-

bling and alcohol, tobacco products, and weapons production are a few examples of these activities.

X. CONCLUSION

During the last twenty years, a large-scale growth in Islamic finance has grown in Muslim countries and around the world. This growth was a result of several factors such as the desire for sociopolitical and economic systems based on Islamic principles and a stronger Islamic identity. Islam remains the fastest growing religion in the world. Muslims now constitute about 27 percent of the world population. The introduction of broad macroeconomic and structural reforms in financial systems, liberalization of capital movements, privatization, global integration of financial markets, and introduction of innovative and new Islamic products have also paved the way for the expansion of Islamic finance. Islamic finance is now reaching new levels of sophistication. However, a complete Islamic financial system with identifiable instruments and markets is still at an early stage of evolution. Many problems and challenges relating to Islamic instruments, financial markets, and regulation must be addressed and resolved.

The lack of developed markets in which Islamic financial instruments can be traded is one of a number of problems caused by lack of cooperation among Muslim financial institutions. There is disagreement over what is prohibited and over the terminology used. There is a shortage of recognized instruments, and the legitimate use of each instrument is also a subject of dispute. Banks' regulation is different at different countries and range from under regulation which allowed the defunct Bank of Credit and commerce International to set up so easily in Abu Dhabi to over-regulation such as in Yemen (Freeland 1998).

The further growth and development of the Islamic financial system will depend largely on the nature of innovations introduced in the market. Financial and human resources should be deployed to develop Islamic financial instruments to enhance liquidity, develop secondary and interbank markets, and perform asset/liability and risk management.

The Islamic financial system can also offer alternatives at the microfinance level. Securitization is a step in the right direction, but even this requires more sophistication. More unbundling and repackaging of financial assets to enhance their marketability, negotiability, and liquidity in Islamic financial markets is needed. Current market operations are restricted by the dearth of liquidity-enhancing products; secondary markets lack depth and breadth; and, more important, instruments for asset/liability management are simply nonexistent. We expect that with the expansion of securitization, the customer base of Islamic financial systems will grow as institutional investors, who have access to broader maturity structures and are attracted to the market, the secondary market will develop and asset/liability management will become a reality

because of the collateralized nature of their cash flows. In addition, because of the collateralized nature of their cash flows, real estate, leasing, and trade receivables are also strong candidates for securitization.

An Islamic financial system can play a vital role in the economic development of Islamic and non Islamic countries by mobilizing dormant savings that are being intentionally kept out of interest based financial channels and facilitating the development of capital markets. Further, the development of such systems would enable savers and borrowers to choose financial instruments compatible with their business needs, social values, and religious beliefs.

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